

# SUMMARY ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author: Cedillo Analyst: Kimberly Pantoja Bill Number: AB 106

Related Bills: See Prior Analysis Telephone: 845-4786 Amended Date: 03/19/01

Attorney: Patrick Kusiak Sponsor: California Budget Project

**SUBJECT:** Earned Income Refundable Credit

- ☒ DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced January 16, 2001.
- ☐ AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.
- ☒ AMENDMENTS DID NOT RESOLVE ALL THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as introduced January 16, 2001.
- ☒ FURTHER AMENDMENTS NECESSARY.
- ☐ DEPARTMENT POSITION CHANGED TO \_\_\_\_\_.
- ☒ REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED January 16, 2001, STILL APPLIES.
- ☐ OTHER - See comments below.

## SUMMARY

This bill would:

- create a refundable Earned Income Credit (EIC) equal to 15% of the earned income credit allowed under federal law;
- allow the refundable EIC to reduce regular tax below tentative minimum tax (TMT) for purposes of the alternative minimum tax (AMT) calculation;
- include the refundable portion of the EIC as an overpayment in the provision that specifies when interest starts to accrue on refunds of overpayments; and
- require the Franchise Tax Board (FTB) to train and inform employers regarding how employees may make withholding adjustments to compensate for the EIC.

## SUMMARY OF AMENDMENT

The March 19, 2001, amendments resolved the department's technical concerns by accepting the amendments suggested in the department's analysis of the bill as introduced January 16, 2001. Except for the resolved technical considerations, the remainder of the department's analysis of the bill as introduced still applies. The remaining policy and implementation considerations and departmental costs have been included below.

Board Position:

☐ S ☐ NA ☐ NP  
☐ SA ☐ O ☐ NAR  
☐ N ☐ OUA ☒ PENDING

Legislative Director

Date

Brian Putler

03/27/01

## **POSITION**

Pending.

### **Summary of Suggested Amendments**

Department staff is available to assist with amendments to resolve the implementation concerns discussed below.

An amendment is suggested to provide appropriation language to fund the departmental costs associated with administering the proposed credit.

## **IMPLEMENTATION CONCERNS**

This bill would require regular appropriations by the Legislature to pay for the refundable portion of this credit. If sufficient funds were not appropriated to cover all of the refunds due, the department would suspend payment of the refunds until more funds were appropriated. Interest would have to be paid to refund recipients for the period of time the refund was delayed. This delay would result in additional contacts to the department by refund recipients, which would likely increase departmental costs.

Many individuals eligible for the federal EIC probably have little or no federal or state tax liability and do not have a California filing requirement. Some 620,000 current nonfilers would be required to file tax returns to claim the proposed EIC, which would significantly impact the department's programs and costs.

The proposed credit under this bill would be claimed by low-income individuals. Low-income individuals generally file their tax returns on Forms 540A or the postcard-size 540 2EZ. To minimize the complexity of these returns, the only credit allowed to be reported on these forms is the nonrefundable renters' credit. The department would not add the EIC to the Form 540 2EZ so that the form retains its simplicity. To claim the EIC, individuals who would normally file on Form 540 2EZ would be required to file using the longer Form 540A.

Since the proposed credit is refundable, the credit calculation would need to be shown in the payment section on all personal income tax (PIT) returns except the Form 540 2EZ. This would increase PIT return Forms 540, 540NR, 540X, and potentially the Form 540A by one page. This would result in a significant impact on FTB's operations and costs. Adding a page to these returns will slow the processing of the returns and require additional storage space. The department may be required to lease additional office and file storage space; however, the department would work within available space to the extent possible.

The IRS prepares tax returns for some taxpayers who claim the refundable EIC. Since the proposed California EIC would be based on a percentage of the federal EIC, these taxpayers may expect the FTB to calculate their proposed California EIC. The FTB does not have access to the federal modified adjusted gross income figures (non-taxable and taxable earned income) that are needed for the federal EIC calculation. Therefore, the FTB would be required to request this information from the IRS, which is usually not available until after the filing season. This may delay issuance of refunds until the information becomes available.

Taxpayers entitled to refunds generally file their returns early in the filing season. Since the proposed California EIC is a percentage of the federal EIC, taxpayers may wait to file their returns until after they receive their federal EIC in order to determine the amount of their California EIC, that behavior could have a major impact on the processing of returns and possibly cause delays in the issuance of refunds. The taxpayer error rate on the federal EIC and fraud concerns cause the IRS to adjust many returns. Consequently, the correct federal EIC amount may not be known until after the taxpayer has filed the state return and claimed the proposed California credit. The FTB then would have to issue an assessment to retrieve incorrect refunds. This would result in additional departmental costs.

This bill would require FTB to provide training and information directly to employers; however, the Employment Development Department (EDD), rather than FTB, is responsible for administering the withholding program. If such information could be provided through FTB's normal methods for providing information (i.e., instructions with tax forms, the Tax News newsletter), this provision would not cause significant implementation issues. If this department were required to contact all employers in the state, significant resources would be required to implement this provision. Clarification is needed before the department could implement this portion of the bill.

Under specific provisions of federal law, denial of the EIC is treated as a deficiency, subject to protest and appeal. The bill does not specify whether a claimant would have protest and appeal rights upon denial of the proposed California EIC. It is unclear if denial of the state EIC would entitle the taxpayer to protest and appeal rights.

The bill does not specify if taxpayers would be subject to the same penalties as provided under federal law due to reckless or intentional disregard of the rules or because of fraud in claiming the state credit.

## **FISCAL IMPACT**

First year implementation costs are estimated at \$6.5 million for fiscal year 2001-2002 and \$5.3 million for fiscal year 2002-2003. Amendment 1 is provided to suggest language for an appropriation to fund these departmental costs.

The estimated costs include printing and processing returns for a large number of people who currently do not have a filing requirement but would file solely to claim the refundable EIC. The number of new filers is estimated to be 620,000 for the first year and 490,000 returns thereafter. The number of estimated new filers has decreased from the department's analysis of the bill as introduced. The prior estimate included an overlap of expected new filers from the dependent care credit. The estimated costs also include processing refunds for an estimated 2.6 million current filers in the first year and 2.1 million thereafter who would qualify to claim the credit.

The addition of the EIC to the tax forms and instructions would cause Forms 540, 540NR, 540X, and potentially 540A to expand to another page. This additional page would significantly slow the processing of those returns, which causes the department to incur additional costs.

The credit is based on the allowance of the credit at the federal level. It is not possible for the department during processing of the state return to determine if the federal credit was allowed. To avoid the cost of paying interest on the refund created by the credit, the FTB would calculate the amount of the federal credit and then apply 15% for state purposes. Computer processing systems would have to be modified to calculate the federal credit.

Other costs include changes to the computer systems, increased taxpayer phone calls and correspondence, and electronic and paper storage.

Significant costs may be generated if the department has to collect erroneously issued refunds due to fraud or federal EIC adjustments.

An undetermined number of fraud investigators would be required to verify this credit. Costs have not been determined at this time.

Departmental costs associated with providing training and information to employers cannot be determined until this provision has been clarified.

### **ARGUMENTS/POLICY CONCERNS**

The IRS has experienced a significant number of both invalid returns and fraudulent returns with the refundable federal EIC. According to the Financial Audit Report submitted by the General Accounting Office to the Secretary of the Treasury for Fiscal Year 1999, of the 573,000 tax returns claiming \$1.25 billion in federal EIC (chosen through a screening process of 19.8 million EIC claims), \$1.08 billion (86%) were invalid.

This bill does not specify a repeal date. Credits typically are enacted with a repeal date to allow the Legislature to review the effectiveness of the credit.

### **LEGISLATIVE STAFF CONTACT**

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FRANCHISE TAX BOARD'S  
PROPOSED AMENDMENTS TO AB 106  
As Amended March 19, 2001

AMENDMENT 1

On page 8, line 23, following "SEC. 5" insert:

(a) There is hereby appropriated from the General Fund for expenditure in the 2001-2002 fiscal year the sum of six million five hundred thousand dollars (\$6,500,000) for allocation to the Franchise Tax Board in augmentation of Item 1730-001-0001 of the Budget Act of 2001.

(b) Any funds that are allocated pursuant to subdivision (a) shall be expended by the Franchise Tax Board solely for the purposes of implementation and administration of the Refundable Earned Income Credit under Section 17052.1 of the Revenue and Taxation Code.

SEC. 6.